capital set at any time will be an accident of timing. The result may be a higher or lower cost of capital, but it is clearly not an appropriate outcome for purposes of setting a long-term cost of capital to calculate prices that will be in effect at least for several years.

Third, the *Order* errs because it refuses to consider the supplemental evidence Verizon VA sought to introduce with respect to the appropriate means of accounting for the pertinent regulatory risks, including in particular the unique risks of providing services over UNEs. Only recently, the Commission expressly acknowledged in its *Triennial Review Order* that the UNE cost of capital must take into account "any unique risks (above and beyond . . . competitive risks . . .) associated with new services that might be provided over certain types of facilities." *Triennial Review Order* ¶¶ 680-81, 683. The obvious corollary is that the cost of capital must take into account the risks inherent in the provision of UNEs themselves. As the Commission explained to the Supreme Court, the cost of capital must reflect all the added "risks associated with the regulatory regime to which a firm [providing UNEs] is subject."[56]

Verizon VA witnesses Dr. Howard Shelanski and Dr. James Vander Weide explained in their testimony during this case that the cost of capital should take into account the regulatory risks of the UNE regime and of TELRIC pricing in particular, and noted that Verizon VA's initial proposal would have to be revised upward to take these risks into account.[57] Similarly, Professor Hausman explained that the UNE regime presents particular regulatory risks that

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[56] Reply Brief for Petitioners United States and the FCC, *Verizon Communications, Inc. v. FCC*, Nos. 00-511 *et al.*, at 12 n.8 (July 2001) ("FCC Reply Br.").

[57] Verizon Virginia Inc. Direct Testimony of Dr. Howard Shelanski at 13-14 (July 31, 2001) ("VZ-VA Ex. 101"); Verizon Virginia Inc. Direct Testimony of Dr. James Vander Weide at 5, 41 (July 31, 2001) ("VZ-VA Ex. 104"); Verizon Virginia Inc. Rebuttal Testimony of Dr. James Vander Weide at 30-31 (Aug. 27, 2001) ("VZ-VA Ex. 112"); Verizon Virginia Inc. Surrebuttal Testimony of Dr. James Vander Weide at 11, 21 (Sept. 21, 2001) ("VZ-VA Ex. 118").

require adjustments to UNE prices. *See generally* Verizon Virginia Inc. Rebuttal Testimony of Dr. Jerry Hausman at 3-4 (Aug. 27, 2001) ("VZ-VA Ex. 111"). Specifically, the risks of providing UNEs are similar to the risks inherent in cancelable operating leases, where the lessees may opt to cancel and the lessor bears the risk that the asset will sit idle or that rates may decrease This is why, for example, the daily cost to rent a car is greater than the cost per day of a long-term car lease. This same risk is inherent in the provision of UNEs, because CLECs are free to terminate their use of a particular element or of UNEs generally at any time, and instead move to alternative facilities or technologies. And even if CLECs do continue to use the incumbent's UNEs, they nonetheless are able essentially to "cancel" their existing UNE leases and renew them at the lower rates that are set every few years based on new hypothetical network assumptions.

The *Order* does not deny the existence of these risks — instead, it suggests that Verizon VA did not quantify them. *See Order* ¶ 61 n.195. However, Professor Hausman did offer a calculation as to one way to account for these risks. *See* VZ-VA Ex. 111 at 18-19 (proposing markup factors). And, while Verizon VA did not include a specific risk premium in its cost of capital to account for these added risks at the time the initial cost studies were completed, Verizon VA's supplemental evidence contained just such a calculation. That evidence showed that, using a well-accepted methodology commonly used to value similar options in financial markets, the cost of capital used to set UNE prices in this case should include a 5.41% risk premium. VZ-VA Proffer at 14-17.

B. The *Order*'s Adoption of Outdated Regulatory Prescribed Depreciation Lives Rather than GAAP Lives Is Erroneous.

The *Order*'s adoption of depreciation lives prescribed by the Commission in 1994 and 1995 (and modified in 1999) is inconsistent with TELRIC. The Commission only recently reiterated that depreciation should be based on "economic lives" and that depreciation therefore "should reflect any factors that would cause a decline in asset values, such as competition or advances in technology." *Triennial Review Order* ¶ 685. As AT&T has conceded, "if a competitive environment makes it more likely that an incumbent's capital will be devalued (say by entry or by more rapid technical progress), TELRIC depreciation will reflect this." *Id.* n.2054 (citing AT&T ex parte). And Commission Staff has recently acknowledged that TELRIC will not permit the recovery of investment costs unless assets are depreciated over very short periods equal to the intervals in which UNE prices are set. *See* OSP Working Paper at 1-2, 43.

By definition, lives prescribed years ago — before even the passage of the 1996 Act — cannot meet this standard. Clearly, competition and technology have both changed significantly in the intervening time period. Indeed, Verizon VA sought to introduce additional evidence concerning changes in the competitive environment in the Virginia telecommunications market just since the record closed (let alone since 1994), but the Bureau refused to consider it. The evidence showed, among other things, that intermodal competition has continued to grow from cable, wireless, Internet telephony providers, and e-mail and instant messaging. VZ-VA Proffer at 9-12. The result of these and other developments is that, for the first time ever, both the number of lines and switched access minutes of use served by Verizon VA have declined for several consecutive years. Lives set in the mid-1990s clearly cannot account for these competitive developments or changes in technologies since then.

By contrast, GAAP lives are intrinsically forward-looking and are specifically designed to take account of the technological changes, competition, and other factors that may decrease the period during which the asset will produce economic value.[58] Moreover, GAAP lives are reassessed annually or even more frequently to reflect events and circumstances that affect that economic life.[59] Moreover, GAAP depreciation lives are a relatively objective and transparent measure, since they are used for financial reporting purposes. Companies have an incentive to state the correct economic lives because using unreasonably short lives in financial reporting would increase their reported costs and result in lower reported profits and stock prices. The Commission itself has approved the use of GAAP lives in setting UNE prices.[60] As the Commission has observed, "a state may find that a depreciation schedule such as [one based on GAAP] is appropriate, and AT&T has failed to indicate why it would not be so here." *Kansas/Oklahoma 271 Order* at 6274 ¶ 76.

The *Order* summarily rejects the use of GAAP on the grounds that Verizon VA generally did not provide sufficient documentation concerning its GAAP lives and did not "demonstrate that [its proposed] lives are in fact compliant with GAAP." *Order* ¶ 116. That is nonsensical. Verizon VA is required by law to file GAAP-compliant lives in its securities filings, and its auditors must certify such compliance. The *Order*'s suggestion that such certification is not sufficient and that Verizon VA somehow has to prove it is not violating the law is well beyond

58/ *See* Verizon Virginia Inc. Direct Testimony of Allen E. Sovereign at 15-17 (July 31, 2001) ("VZ-VA Ex. 106").

59/ *See* Verizon Virginia Inc. Direct Testimony of John Lacey at 4-6 (July 31, 2001) ("VZ-VA Ex. 105"); Tr. at 3323 (Lacey); VZ-VA Ex. 106 at 5, 15-17.

60/ *Kansas/Oklahoma 271 Order* at 6273 ¶ 74; *see* Reply Declaration of Daniel J. Whelan and Gary E. Sanford, *Application by Verizon Pennsylvania Inc. et al. for Authorization to Provide In-Region, InterLATA Services in Pennsylvania*, FCC 01-269, CC Docket No. 01-138, at 16-18 (Aug. 2001).

any reasonable evidentiary standard. The Commission should reverse the *Order* and adopt GAAP lives.

C. The *Order* Significantly Understates Costs Resulting from Uncollectibles.

The *Order* leaves in place the uncollectibles proposals provided by each party for use in their respective models. *Order* ¶ 150. In so doing, the *Order* dramatically understates costs. Both the Commission and even AT&T have recognized that rates should be set at a level sufficient to compensate carriers for any charges that cannot be collected.[61]

The *Order* violates this rule. First, it ignores Verizon VA's proffered evidence demonstrating that its experience since the initial studies were submitted in this case shows that the uncollectibles rate for the provision of UNEs is more than 45 times higher than the proxy uncollectibles figure Verizon VA used in its initial studies. *See* VZ-VA Proffer at 12-14. At the time Verizon VA completed its cost studies, it still had limited experience collecting wholesale charges from CLECs and therefore used as a proxy the historical uncollectible rate of 0.56% for traditional access and similar services. More recent experience demonstrates that wholesale uncollectible rates are substantially higher than the access proxy. In 2001 and 2002, for example, the wholesale uncollectible rate averaged 11% across the Verizon East footprint, and more than 25% in Virginia alone, even without including uncollectible charges as a result of the WorldCom bankruptcy. *See id.* In fact, the Commission itself has recognized that the

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[61] *See* Policy Statement, *Verizon Petition for Emergency Declaratory and Other Relief*, 17 FCC Rcd 26884, 26889 ¶ 9 (2002) ("Policy Statement Regarding Petition for Emerg. Decl.") ("the Commission's ratemaking policies for incumbent LECs also account for interstate uncollectibles and provide for their recovery through interstate access charges"); *see also* Letter from James W. Cicconi, General Counsel and Executive Vice President, Law & Government Affairs, AT&T Corp. to Honorable Michael Powell, Chairman, Attachment at pp. 1-2 (July 26, 2002) ("Cicconi Letter").

uncollectible rate going forward will be many times the historical access proxy rates (on the order of 4% to 5%) even for more stable lines of business.[62]

Second, the *Order* compounds the underrecovery caused by its refusal to consider this evidence by prohibiting Verizon VA from collecting disconnect charges at the time of connection. The *Order* bases this decision at least in part on the basis that Verizon VA could account for any shortfall in recovery through its uncollectibles factor, yet it does not even propose its own upward adjustment to Verizon VA's uncollectibles figure. *See Order* ¶ 598. Similarly, as discussed below, the risk involved in the *Order*'s requirement that non-recurring costs be recovered through recurring rates also requires an assumption of higher uncollectibles. The uncollectibles rate in Verizon VA's supplemental evidence does not even account for these added risks. The Commission should consider Verizon VA's supplemental evidence and, at minimum, adopt the wholesale uncollectibles rate contained therein.

D. The *Order* Significantly Understates Verizon VA's Forward-Looking Expenses.

The *Order* gerrymanders the calculation of annual expenses so that Verizon VA is not permitted to recover a significant portion of its forward-looking expenses. It does so in two ways. First, while the *Order* generally adopts (with adjustments) Verizon VA's cost factors that are used to translate investment into annual expenses, the *Order* omits a critical conversion factor that is necessary to produce the correct level of forward-looking expenses. The effect of this omission, as the New York Commission noted, is to "twice TELRIC[]" the resulting

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[62] Wireline Competition Bureau Staff Study of Alternative Contribution Methodologies, CC Docket Nos. 96-45, *et al.* at 5-8 (rel. Feb. 25, 2003) ("Staff Study") (assuming uncollectible rates of 4-5%).

expenses by "double counting the TELRIC" reduction.[63] Second, the *Order* compounds this error by applying another adjustment that reduces expenses yet again. As a result, the expenses resulting from the *Order* effectively have been "triple-TELRIC'ed" and understate costs dramatically.

1. The *Order* Omits a Critical Conversion Factor Necessary To Produce Accurate Forward-Looking Expenses.

The *Order* excludes an important factor that allows Verizon VA's annual cost factors ("ACFs") to yield appropriate forward-looking expenses. The *Order* asserts that this factor, called the "forward-looking-to-current" conversion factor (the "FLC"), is used to "calculate forward-looking expenses," *Order* ¶ 139, and it then rejects the FLC on the basis that it "does not produce a meaningful estimate of forward-looking expenses," *id.* ¶ 140. But this is wrong. The FLC is not used to calculate or estimate anything. The FLC is applied to the ACFs only *after* Verizon VA has calculated its forward-looking expenses, and its sole purpose is to ensure that when Verizon VA's ACFs are applied to forward-looking *investment* in Verizon VA's studies, the identified level of forward-looking expense is produced.

The FLC is a factor unique to the manner in which Verizon VA develops its ACFs. First, as the Bureau itself recognized, Verizon VA estimates the appropriate level of forward-looking expenses by examining past expenses and adjusting these for inflation and productivity, and reducing certain maintenance expenses. *Id.* ¶¶ 125-27, 141. Verizon VA then develops its ACFs as a ratio comparing these forward-looking expenses to *embedded* investment. But in the cost studies, the ACFs are ultimately applied to forward-looking TELRIC investment in order to

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[63] *New York UNE Order* at 58 (quoting Recommended Decision in Module 3, *Proceeding on Motion of the Commission to Examine New York Telephone Company's Rates for Unbundled Network Elements*, Case No. 98-C-1357, 2001 N.Y. PUC LEXIS 293, at *140 (N.Y. Pub. Serv. Comm'n May 16, 2001) ("*New York Recommended Decision*")).

produce the relevant UNE costs. As a function of simple mathematics, since the TELRIC investment level is typically lower than embedded investment, applying the ACFs to the TELRIC investment without the FLC adjustment will produce a level of expense far lower than the forward-looking expenses that were identified as appropriate.

For example, assume Verizon VA currently incurs $150 in expenses to maintain a piece of equipment that originally cost $1,000, and calculates that, with forward-looking adjustments, it will cost only $100 to maintain that equipment. The ACF would be $100/$1000 or 0.10. Next assume that the forward-looking TELRIC investment cost for the equipment is deemed to be $800 When Verizon VA applies its ACF of 0.10 to that TELRIC investment, it will yield expenses of only $80 — $20 less than the $100 that *already has been determined as the correct level of forward-looking expenses.* VZ-VA Ex. 107 at 70-72; VZ-VA Initial Br. at 66-68.

That result makes no sense. If Verizon VA's ACFs are applied to TELRIC investment without adjustment, forward-looking expenses are reduced below the identified levels, which already reflect productivity improvements, *solely* because the investment cost of the assets has been reduced. But as the *Order* itself recognizes, "expenses do not change in exact proportion to changes in the value of assets." *Order* ¶ 141. The New York Commission similarly explained that "a reduction in investment could not be assumed to imply a comparable reduction in expenses."[64] As the New York Commission noted, applying the cost factors in Verizon VA's studies without the FLC accordingly "will underrecover expenses to a degree" unrelated to any proper calculation of TELRIC. *New York UNE Order* at 57.

[64] Order on Unbundled Network Element Rates, *Proceeding on Motion of the Commission to Examine New York Telephone Company's Rates for Unbundled Network Elements*, Case No. 98-C-1357, at 57 (N.Y. Pub. Serv. Comm'n Jan. 28, 2002) ("*New York UNE Order*").

The FLC prevents this anomalous result The FLC is used to adjust the embedded investment in the denominator of the ACFs to account for the relationship between embedded and forward-looking investment.[65/] As the New York Commission noted, application of the FLC prevents "twice TELRIC-[ing]" or "double counting the TELRIC" reduction in expenses. *New York Recommended Decision* at *140. Thus, in the example above, applying the FLC to the 0.10 ACF will ensure that Verizon VA recovers the $100 that has been identified as the appropriate level of adjusted, *forward-looking* expense. Contrary to the *Order*'s erroneous statements, applying the FLC does *not* allow Verizon VA to recover its $150 of *embedded* expenses, nor is it used to "calculate" or "estimate" the $100 that is recovered.[66/]

The rejection of the FLC thus was a material error of fact that must be corrected on review. If this decision is not reversed, Verizon VA will grossly underrecover the expenses associated with the UNEs, including switching and transport, for which Verizon VA's own studies are used [67/] As the Pennsylvania commission observed, the real "argument is not with the FLC itself but with the issue of whether Verizon's TELRIC expense levels are truly forward-looking Our adjustments to expenses are designed to ensure that they are forward-looking and thus, would negate [the CLECs'] arguments for rejecting the FLC." *Pennsylvania Tentative*

65/ Verizon VA used a conservative FLC of 80% as a placeholder in its studies, but that FLC would have to be adjusted now to account for the actual relationship between the booked investment used in developing the ACFs and the TELRIC investment amounts approved in the *Order*. *See* VZ-VA Ex. 107 at 74-75 In the example provided above, the FLC would be 80%, making the final ACF .125 instead of .100.

66/ The New York Commission also noted that the FLC does not allow Verizon to recover its embedded expenses: "even with the FLC applied, [Verizon's] studies reflect only $5.316 billion in recognizable costs, in contrast to its claimed actual costs of $7.571 billion." *New York UNE Order* at 57.

67/ The FLC is not relevant to expenses based on AT&T/WorldCom's model, because it uses a different approach to estimating expenses.

Order at 60. Similarly here, the *Order* already reduces the forward-looking expenses that Verizon VA may recover by, for example, removing all marketing expenses from its studies. *Order* ¶¶ 144-45. The remaining forward-looking expenses thus should be the amount that Verizon VA is permitted to recover, and its studies cannot produce rates that recover that amount if the FLC is eliminated.

Moreover, the effect of eliminating the FLC is exacerbated by the *Order*'s dramatic reductions in investment. The *Order* has slashed Verizon VA's switching investment by requiring, for example, as noted above, that over 90% of Verizon VA's switching investment be priced at a discount as high as 99% off the list price. If Verizon VA's ACFs are applied to this substantially reduced level of investment without the FLC adjustment, the expenses that will be produced will be enormously reduced.[68] Verizon VA's transport investment was similarly slashed by the *Order* when it required Verizon VA to assume 3.79 nodes per OC-48 SONET ring, instead of the six nodes per ring proposed in Verizon VA's study. *Order* ¶¶ 512, 514. Because of the dramatically lower investment in IOF, absent the FLC, those expenses will be grossly underrecovered as well.

2. The *Order* Compounds the Underrecovery Caused by the Rejection of the FLC by Applying an Alternative Adjustment That Further Reduces Expenses.

The *Order* compounds the error it made by rejecting Verizon VA's FLC by requiring Verizon VA to use a different ratio in developing its ACFs. But this is not, as the *Order* suggests, a "better approach." *Id.* ¶ 140. To the contrary, it is an insufficient adjustment that

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[68] For example, if an ACF is .10 based on $1000 in embedded investment and $100 in forward-looking expenses, and the forward-looking investment is deemed to be $800, then applying that ACF without the FLC yields expense recovery of $80; but if the investment is reduced to $500 instead, then the resulting expense recovery without the FLC is $50, even though the forward-looking expenses are actually $100.

actually *further* reduces Verizon VA's recoverable expenses without any showing whatsoever that expenses will decline by more than the productivity gains *already* assumed in Verizon's studies, and therefore effectively "triple TELRICs" expense reductions by reducing the expenses a third time.

The adjustment required by the *Order*, called the current-cost-to-booked-cost ("CC/BC") ratio, is designed to take embedded investment and convert it into what it would cost in *current* dollars to purchase the same asset. *See id.* For example, the CC/BC ratio could be used to estimate how much a computer purchased in 1987 would cost in today's dollars. *See* VZ-VA Ex. 122 at 30. The *Order* never explains why *current* investment costs have any relevance to the development of ACFs for a *forward-looking* TELRIC study. Applying a CC/BC ratio to the embedded investment in the denominator of Verizon VA's ACFs, as the *Order* requires, would create a ratio of *forward-looking* expense to *current* investment. In order to make the ACFs applicable to *forward-looking* TELRIC investment, the ACFs would still have to be further adjusted to account for the relationship between *current* investment and *forward-looking* investment. The Massachusetts commission flatly rejected use of the CC/BC ratio precisely because it failed to make the denominator of Verizon VA's ACFs *forward-looking*, and instead merely made it current. As the Massachusetts commission found:

> When calculating the Expense-to-investment ratio ("E/I ratio"), there should be a consistency between the numerator and denominator in terms of the time period and network assumption . . . . [W]e agree with Verizon that as forward-looking expenses are used in the numerator, it is only logical to adjust the denominator (the current investments) by the FLC to make it forward-looking.[69]

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[69] Order, *Investigation by the Department of Telecommunications and Energy on its Own Motion into the Appropriate Pricing, Based upon Total Element Long-Run Incremental Costs, for Unbundled Network Elements and Combinations of Unbundled Network Elements, and the*

Use of an ACF adjusted solely by the CC/BC ratio will artificially underrecover expenses.

Indeed, because the average of the CC/BC ratios adopted by the Bureau is approximately 1.287, *see Order* ¶ 140 n.388 (citing *Inputs Order* at 20420, App. D at D-4), application of the CC/BC ratio here in lieu of the FLC actually produces a huge *reduction* in Verizon VA's recoverable expenses While the *Order*'s TELRIC adjustments to Verizon VA's switching and transport investment substantially *reduce* investment, a CC/BC adjustment above 1.0 *increases* investment, as the Bureau itself recognizes *See id.* ¶ 140. Applying the CC/BC ratio thus increases the denominator in the ACF calculations, and accordingly reduces the ACF and the overall expenses that are recovered.[70] But the *Order* requires this reduction without *any* showing that forward-looking expenses will be reduced because of productivity gains beyond that assumed in Verizon VA's studies, and *solely* on the ground that investment costs will change. In light of the *Order*'s recognition, noted above, that expenses do *not* change in proportion to assets costs, *Order* ¶ 141, this result is arbitrary and capricious.

The fact that the CC/BC was used in the *Inputs Order*, as the *Order* notes, is irrelevant. Neither the universal service Synthesis Model nor AT&T/WorldCom's modified Synthesis Model develops ACFs in the manner in which Verizon VA does, using *forward-looking*

Appropriate Avoided-Cost Discount for Verizon New England, Inc. d/b/a Verizon Massachusetts' Resale Services in the Commonwealth of Massachusetts, Docket No. D.T.E. 01-20, at 95 (Mass. Dep't of Telecomm. and Energy July 11, 2002) ("*Massachusetts UNE Order*").

[70] A numerical example illustrates this point: assume, as above, $100 in forward-looking expense for a piece of equipment with a book investment cost of $1,000. Applying the 1.287 CC/BC ratio would convert the $1,000 embedded investment in the ACF denominator to approximately $1,280. The resulting ACF would be approximately .078 ($100 divided by $1,280), instead of 0.10. And if TELRIC investment is assumed to be, for example, 80% of embedded investment, as in the example above (reducing the $1000 booked investment cost to a TELRIC cost of $800), applying the CC/BC-adjusted ACF would identify only approximately 62% of the identified forward-looking expenses. (.078 x $800 = $62.4 instead of $100).

expenses in the numerator. Indeed, the *Order* recognizes that the CLECs use 1997 and 1998 expenses. *Id.* ¶ 132. The issue here is solely how ACFs developed in Verizon VA's cost studies should be adjusted, and in that context, the FLC is critical and the CC/BC inappropriate. In other instances where the modified universal service model and Verizon VA's models operate differently, the *Order* recognizes that it should retain the approach that is appropriate for use in conjunction with each of the two models. *See, e.g., id.* ¶ 150 (uncollectibles); *id.* ¶ 159 (OSS expenses). The failure to recognize that same requirement in this instance should be reversed.

III. NON-RECURRING COSTS

The *Order* also errs by adopting AT&T/WorldCom's non-recurring cost model, which is based on extreme assumptions that do not permit Verizon VA to recover the out-of-pocket costs it incurs to provide UNEs. The *Order* thus is inconsistent with the Commission's long-standing recognition that "LECs should . . . recover . . . their full one-time costs of providing, terminating or modifying a[] . . . service. This is consistent with our policies encouraging the recovery of costs from cost causers and would reduce the subsidy of short-term users by longer term customers."[71] As the Commission has explained, non-recurring tasks "clearly generate[] costs for the LECs. To the extent that customers seek to avoid such costs, they seek a subsidy. The creation of such a subsidy would be at odds with our stated goal of achieving cost-based . . . rates."[72]

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[71] Memorandum Opinion and Order, *Investigation of Interstate Access Tariff Non-Recurring Charges*, 2 FCC Rcd 3498, 3501-02 ¶¶ 32-33 (1987) ("*Non-Recurring Charges Order*"); *see also id.* 3499, 3502 ¶¶ 12, 35.

[72] Memorandum Opinion and Order, *Investigation of Special Access Tariffs of Local Exchange Carriers*, CC Docket No. 85-166, 1986 FCC LEXIS 4103, at *13 (Jan. 24, 1986).

Notwithstanding this Commission requirement, the *Order*'s adoption of AT&T/WorldCom's model creates just such subsidies. There is no dispute that AT&T/WorldCom's model "does not include certain types of costs" and "recovers more costs through recurring charges" even though those costs are non-recurring in nature. *Order* ¶¶ 569, 584 [73/] Indeed, AT&T/WorldCom's model includes only 31 NRCs (plus another 18 separately stated disconnection NRCs), while Verizon's reflects *115* NRCs. *Id.* ¶¶ 581-82. The model thus clearly does not fully account for all of Verizon VA's non-recurring costs.

In particular, the model denies Verizon VA recovery of its non-recurring costs in two ways First, it improperly shifts most non-recurring costs to recurring rates, and thereby requires Verizon VA to bear the financial risk of the CLECs' entry. Second, the model ignores other non-recurring costs and drastically understates even the costs it does estimate, and therefore leads to gross underrecovery. The *Order* is thus contrary to Commission precedent and creates yet another subsidy for CLECs that rely on Verizon VA's network. The Commission should instead adopt Verizon VA's non-recurring cost model.

A. The *Order* Improperly Requires Verizon VA to Recover Most Non-Recurring Costs Through Recurring Rates.

The *Order*'s decision to adopt AT&T/WorldCom's NRC model must be rejected because it is based in large measure on the incorrect premise that most non-recurring costs should be recovered through recurring charges. As an initial matter, the *Order* has improperly prejudged significant new policy issues pending before the Commission. In the *TELRIC NPRM*, the Commission is specifically considering the "difficult decision" whether it should change its own

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[73/] *See also* Verizon Virginia Inc. Non-Recurring Cost Panel Rebuttal Testimony at 8, 13-14, 25-26, 38, 42, 45 (Aug, 27, 2001) ("VZ-VA Ex. 116"); Verizon Virginia Inc. Non-Recurring Cost Panel Surrebuttal Testimony at 13-15 (Sept. 21, 2001) ("VZ-VA Ex. 124").

long-standing policies and precedent and require incumbent LECs to recover non-recurring costs in recurring rates, and if so, in what circumstances. *TELRIC NPRM* ¶¶ 121-24. And the Commission recognized that any such change would have to be crafted with care to ensure that incumbents appropriately recovered their costs *Id.* ¶ 123. The *Order*, however, makes this far-reaching decision in two paragraphs of discussion without any attention to the various concerns raised by the Commission.

Moreover, the *Order*'s decision is inconsistent with established Commission policy. As explained above, the Commission's rules and decisions establish that UNE costs should be recovered in the manner they are incurred. With respect to non-recurring costs in particular, the Commission has consistently recognized that "LECs should . . . recover through an NRC their full one-time costs of providing, terminating or modifying a[] . . . service. This is consistent with our policies encouraging the recovery of costs from cost causers and would reduce the subsidy of short-term users by longer term customers." *Non-Recurring Charges Order* at 3501-02 ¶¶ 32-33; *see also Local Competition Order* at 15874 ¶ 743. The Commission specifically found that "[l]oad[ing] the unrecovered non-recurring costs into recurring rates" would be "inconsistent with the policies . . . that favor recovering costs from the cost causer" and "would distort the prices paid by . . . customers."[74] Although the *Order* notes that the *Local Competition Order* suggests that in certain cases a state may permit the recovery of a non-recurring cost through recurring rates, the *Order* treats that exception as though it swallows the "general rule[] that

[74] *Non-Recurring Charges Order* at 3499 ¶ 12, 3502 ¶ 35; Order, *MCI Telecommunications Corp. Application for Review of the Ameritech Operating Companies, Bell Atlantic Telephone Companies, BellSouth Telecommunications Inc., Cincinnati Bell Telephone Company, GTE Service Corporation, the NYNEX Telephone Companies, Pacific Bell, Rochester Telephone Corp., Southern New England Telephone Company, Southwestern Bell Telephone Company, United Telephone and Central Telephone Companies, and U S WEST Communications*, 12 FCC Rcd 16565, 16571 ¶ 12 (1997).

incumbent LECs' rates for interconnection and unbundled elements *must* recover costs in a manner that reflects the way they are incurred." *Local Competition Order* at 15874 ¶ 743 (emphasis added). Simply put, "LECs should not be forced to underwrite the risk" of CLECs' entry.[75] The *Order* violates these existing Commission principles and should be reversed for that reason alone.

The *Order* suggests that the shift of non-recurring costs to recurring rates is appropriate because large non-recurring costs allegedly pose an entry barrier. But to reach that result, the *Order* must ignore the fact that non-recurring charges set at cost simply reflect the true costs of entry. And, as Dr. Shelanski explained, recovering such costs through non-recurring rates is necessary to ensure efficient entry decisions: "[i]f the CLEC, which is causing the NRC through entry over the incumbent's facilities, does not pay that cost, then it is not bearing the full costs of its entry and will not make efficient entry decisions." Verizon Virginia Inc. Rebuttal Testimony of Howard Shelanski at 16 (Aug. 27, 2001) ("VZ-VA Ex. 110").

The *Order* also should be reversed for the separate reason that it wholly fails to address the problems caused by shifting recovery of non-recurring costs through recurring rates. Such a shift requires estimating how long the average customer will take service — an uncertain exercise at best that almost inevitably will create a substantial risk of underrecovery for Verizon VA. The *Order* itself acknowledges this difficulty in another context, finding Verizon VA's proposal to collect disconnect charges at the time of connection would be "complicated and . . . prone to error" because it would "require[] an assumption as to how long the competitive LEC will retain a customer." *Order* ¶ 597. In effect, the *Order* requires Verizon VA to act as the

[75] Second Report and Order, *Local Exchange Carriers' Rates, Terms, and Conditions for Expanded Interconnection through Physical Collocation for Special Access and Switched Transport*, 12 FCC Rcd 18730, 18750 ¶ 33 (1997).

CLEC's banker, extending credit to the CLEC for immediate cash outlays that Verizon VA will recover, if at all, only through periodic payments over time.

As the Commission itself previously found, the result is to create a new subsidy that flows from "long term" users of the network — here, the ILECs — to "short term" users — here, the CLECs. *Non-Recurring Charges Order* at 3501-02 ¶¶ 32-33. For example, the non-recurring charge for installing new service using an unbundled loop will be slashed more than 90% from $61.04 to less than $5.00. Even assuming that the $0.67 increase in the recurring loop rate is all intended to recover Verizon's non-recurring cost of installation, it would take nearly *seven years* (even without taking into account the time value of money) before Verizon VA could recover its non-recurring costs for this installation. Yet as the Commission has just recently found, "there is a significant amount of churn . . . among mass market customers." *Triennial Review Order* ¶ 471. Indeed, WorldCom has stated that 50% of its new local customers switch carriers within the first *three* months of signing up for service. *See id.* Under the *Order*'s rate structure, WorldCom would not have to pay a substantial portion of the non-recurring costs associated with these customers. Moreover, the continued spate of CLEC bankruptcies further increases the risk that Verizon VA will be unable to recover its non-recurring costs through recurring rates; indeed, in the last seven years, 140 CLECs in Verizon's service area have filed for bankruptcy, and more than 50 have gone out of business. This shifting of risks and costs from the CLECs to Verizon VA would, at minimum, require adjustments to the uncollectibles figure and an additional risk premium. The *Order* did not address these issues at all and in fact refused even to consider additional evidence concerning uncollectibles and the appropriate risk premium.

B. The *Order*'s Chosen Non-Recurring Model Slashes or Eliminates Non-Recurring Rates for Costs It Does Not Shift to Recurring Rates and Therefore Denies Verizon VA Recovery of Its Out-of-Pocket Costs.

Separate and apart from the *Order*'s decision to shift most non-recurring costs to recurring rates, the *Order* also goes to extremes by adopting a model that drives down or even eliminates rates for activities that even the *Order* agreed should be recovered on a non-recurring basis. This too is ground for reversal.

As noted above, Commission precedent requires that, to avoid creation of uneconomic "subsid[ies]," "LECs should . . . recover . . their full one-time costs of providing, terminating or modifying a[] . . . service." *Non-Recurring Charges Order* at 3501-02 ¶¶ 32-33. The Commission has made clear that if an incumbent must perform work to provide interconnection or access to network elements, it must be compensated for the costs of that work. As the Commission has stated, a CLEC is "required to bear the cost" of "modifications to incumbent LEC facilities to the extent necessary to accommodate interconnection or access to network elements." *Local Competition Order* at 15602-03 ¶¶ 198-99. Conversely, the Commission has expressly rejected claims that some or all of those costs can be assumed away on the theory that they would not have to be incurred in some different hypothetical network. Thus, for example, it has rejected arguments that TELRIC permits assuming that a hypothetical future network would no longer require certain tasks, such as loop conditioning, that unquestionably have to be performed in the real world and found that the CLEC must "bear the cost of compensating the incumbent LEC" for "modification of incumbent LEC facilities, such as loop conditioning."[76]

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[76] *Local Competition Order* at 15692 ¶ 382; Third Report and Order and Fourth Further Notice of Proposed Rulemaking, *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, 15 FCC Rcd 3696, 3784 ¶ 193 (1999); FCC Reply Br. at 10 n.7 ("[T]he [] suggestion . . that TELRIC authorizes regulators to require incumbents to modify,

The *Order*'s adoption of AT&T/WorldCom's non-recurring cost model is inconsistent with these rules. First, that model does not even produce rates for a number of activities that even the *Order* agreed should be recovered on a non-recurring basis. In other cases where the CLECs' model did not produce a cost, the *Order* determines that it would rely on Verizon VA's studies. *See, e.g., Order* ¶ 554 Indeed, this principle is required by the *Order*'s supposed allegiance to its "baseball arbitration rules." *Order* ¶ 24. Yet for the activities that AT&T/WorldCom's non-recurring cost model does not produce — which include line sharing and loop conditioning — the *Order* has instead invited AT&T/WorldCom to now "add these NRCs to their model and calculate the charges accordingly." *Id.* ¶ 618; *see also id.* ¶¶ 639, 642, 648.

The fact that the Bureau must go to such lengths to resuscitate AT&T/WorldCom's model demonstrates its inadequacy for use in setting non-recurring rates. And the *Order*'s approach is also manifestly unfair. While the *Order* suggests that the new NRCs are just outputs of AT&T/WorldCom's non-recurring cost model, this is not the case. AT&T/WorldCom's model specifically assumes that costs such as loop qualification and conditioning are not necessary in the forward-looking environment. Thus, modeling costs for these new elements is not simply a matter of running the model to produce new calculations. Instead, AT&T must return to its subject matter "experts," have them reach a consensus regarding how an activity might be performed, how frequently, and at what duration, and only then, from this new evidence, calculate a cost. Verizon VA will have no opportunity to engage in discovery or cross-examine the relevant witnesses or otherwise test this new evidence. This outcome is particularly

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'for free,' loops to facilitate certain advanced services ignores express FCC directions to the contrary.") (citations omitted).

arbitrary since the Bureau refused to consider Verizon VA's supplemental evidence that it proffered months ago, well *before* the *Order*.

Second, the *Order* unlawfully denies Verizon VA recovery of its out-of-pocket costs because even those rates that AT&T/WorldCom's model does produce are based on extreme hypothetical assumptions that drive rates down well below cost. As in the case of its digital loop carrier technology assumptions, the *Order* ignores the Commission's "currently available" technology limitation in favor of mere technical feasibility. The *Order* itself describes the AT&T/WorldCom model as "interpreting 'currently available' as any technology that is *theoretically feasible*, even if it has not actually been implemented by any carrier." *Id.* ¶ 568 (emphasis added). As discussed above, however, the Commission requires that, if a technology is to be considered for TELRIC purposes, it is not sufficient that it is "theoretically feasible" at some future time; instead, it must be *currently available* for deployment. As the Commission only recently stated, "it is not appropriate to consider technologies that may be available in the future but are not currently available." *Triennial Review Order* ¶ 670 n.2020.

Yet AT&T/WorldCom's model is premised on "theoretically feasible" OSS and other technologies that allegedly would allow most tasks to be performed in an automated fashion. But the unequivocal record evidence demonstrated that such technology is not "currently available" and does not, for example, permit *any* carrier to process orders automatically with only 2% fallout. VZ-VA Ex. 116 at 13-22; VZ-VA Ex. 116 at 16-17. The *Order* does not even mention this evidence and simply asserts, without any support, that this assumption is somehow "consistent with TELRIC requirements." *Order* ¶ 592. The result is that Verizon VA will be unable to recover the costs it incurs to provide UNEs using currently available technologies and instead will be forced to subsidize CLEC entry.

The AT&T/WorldCom model is further flawed because, as the *Order* recognizes, its cost assumptions "are based *solely* on the subjective opinion of [AT&T's] subject matter experts." *Id* ¶ 571 (emphasis added). These so-called experts admittedly had no experience in processing wholesale UNE orders or provisioning UNEs and, for any given task, only "one or two" panel members even purported to have *any* expertise at all. Tr. at 4650-54. The result is time and frequency estimates that are well below the real-world times and frequencies of performing relevant tasks.[77]

C. The *Order* Wrongly Rejects Verizon VA's Non-Recurring Cost Model.

In contrast to AT&T/WorldCom's model, Verizon VA's non-recurring model simply calculates the costs it will actually incur for a given task based on empirical data. While AT&T/WorldCom's model is based "solely" on subjective opinion, Verizon conducted an extensive survey of its workers with real-world experience to determine how long a particular task currently takes and the frequency with which it is performed. The survey results were validated by a statistician, and then subject matter experts made forward-looking adjustments to the resulting time and frequencies where currently available technologies would enable those tasks to be performed more efficiently. VZ-VA Ex. 107 at 311, 316-17. In the case of order processing tasks, these times were validated by an independent third-party (Andersen

[77] To take just one example, the AT&T/WorldCom model assumes that it takes only one minute to place a wire from the frame to the CLEC's equipment in the process of performing a hot cut. That makes no sense. unless Verizon VA had technicians stationed at numerous locations around every frame just waiting to perform a hot cut, it will take more than a minute simply to locate the appropriate cross connect location on the frame for the customer that needs to be cut over. Verizon VA's data, based on surveys of workers who actually perform hot cuts, showed that placing the wire to the CLEC frame in fact takes an average of 8 minutes. *See* Verizon NRC Model at Tab 3, CO Frame, Line 6. And while that figure itself is not large, and means that Verizon can quickly and efficiently complete the transfer, it nonetheless differs materially from the wholly hypothetical one minute assumed by the AT&T/WorldCom model.

Consulting) *Id.* at 313-14. Moreover, an outside consultant then reviewed the statistical precision of Verizon VA's non-recurring cost estimates and calculated 95% precision levels for Verizon VA's non-recurring costs. For all but a few UNEs, the consultant calculated that there was a 95% probability that Verizon's non-recurring cost estimates were within 15% of the actual cost Verizon VA will incur to perform the relevant task. *Id.* at 325. Thus, as even the *Order* concedes, Verizon VA provides "*more* support" for its time and frequency estimates than does AT&T/WorldCom. *Order* ¶¶ 571-72 (emphasis added).

Numerous states, including New York, have validated this methodology and relied on Verizon's model to set non-recurring rates.[78] Indeed, Verizon's non-recurring cost model is the product of an extensive review by the New York Commission. Verizon submitted three different iterations of its model in response to concerns raised by the commission and the ALJ. Ultimately, the ALJ adopted all of Verizon's work times, finding that they were well supported and statistically valid. He further concluded that the statistical analysis of time estimates resolved "any concerns about the statistical validity of the study." *New York Recommended Decision* at 188. The New York Commission adopted the ALJ's recommendations, noting that he had "fully recounted both the history of the issue in the earlier proceeding and the basis on which he found Verizon's current studies to be generally acceptable." *New York UNE Order* at

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[78] *New York Recommended Decision* at 186-88; *see also Maryland UNE Order* at 87-88; Decision and Order, *In the Matter of the Board's Review of Unbundled Network Element Rates, Terms and Conditions of Bell Atlantic-New Jersey, Inc.*, Docket No. TO-00060356, at 157-67 (N.J. Bd. Pub. Util. Mar. 6, 2002) ("*New Jersey UNE Order*"); *Massachusetts UNE Order* at 432-500; Findings, Opinion and Order No. 5967, *Application of Verizon Delaware, Inc. (F/K/A Bell Atlantic-Delaware, Inc.), for Approval of Its Statement of Terms and Conditions Under § 252(f) of the Telecommunications Act of 1996*, Docket No. 96-324 Phase II, at 31-35 (Del. Pub. Serv. Comm'n June 4, 2002) ("*Delaware UNE Order*"); Report and Order, *Review of Bell Atlantic-Rhode Island TELRIC Study*, Docket No. 2681, at 62-69 (R.I. Pub. Util. Comm'n Nov. 18, 2001) ("*Rhode Island UNE Order*").

141. Like the New York Commission, this Commission itself has approved rates generated by Verizon's model as TELRIC-compliant in the context of 271 applications.[79]

The *Order* offers no basis for reaching a different conclusion here. While it criticizes Verizon VA's methodology for determining time and frequency estimates, it finds that Verizon VA provides "more support" for its estimates than does AT&T/WorldCom — thus, this criticism can hardly be a reason to choose AT&T/WorldCom's model over Verizon's. The *Order's* suggestion that Verizon's model does not assume sufficiently forward-looking technology, *Order* ¶ 568, makes no sense. The only example it cites is the low percentage of IDLC, yet the Bureau ultimately renders that point irrelevant since it concludes that non-recurring costs for unbundling loops should be based on the assumption "that all loops are copper or UDLC." *Id.* ¶ 601 Thus, the Commission should reject the *Order*'s decision to use AT&T/WorldCom's non-recurring cost model and adopt Verizon VA's instead.

IV. BEFORE THE *ORDER*'S RATES GO INTO EFFECT, THE COMMISSION MUST PROVIDE A MECHANISM TO COMPENSATE FOR THE SHORTFALL BETWEEN THOSE RATES AND VERIZON'S UNRECOVERED HISTORICAL COSTS AND ACTUAL FORWARD-LOOKING COSTS.

The Commission also is legally obligated to evaluate whether the *Order*'s UNE rates would result in confiscation. Both the Act and the Constitution require the Commission to provide for recovery of both Verizon VA's unrecovered historical costs and its actual forward-looking costs. The Bureau did not consider whether the UNE rates it adopted would enable Verizon VA to recover these costs. Accordingly, the Commission is obligated to evaluate

[79] *New Hampshire/Delaware 271 Order* at 18711 ¶ 86; *see also* Memorandum Opinion and Order, *Application of Verizon Pennsylvania Inc., Verizon Long Distance, Verizon Enterprise Solutions, Verizon Global Networks Inc., and Verizon Select Services, for Authorization to Provide In-Region, InterLATA Services in Pennsylvania*, 16 FCC Rcd 17419, 17458-59 ¶ 67 (2001) ("*Pennsylvania 271 Order*"); *Maryland, Washington D.C., & West Virginia 271 Order* ¶¶ 44, 55, 80-83; *Massachusetts 271 Order* at 8998-99 ¶¶ 19-20.

whether application of the *Order*'s TELRIC rates produces a confiscatory outcome and provide a mechanism for compensation if they do so.

The Supreme Court has expressly established that a challenge to the constitutional adequacy of UNE rates becomes ripe at the time that specific rates are set, and the Commission itself has invited incumbents to provide precisely such information.[80] Indeed, the law is clear that the Commission must consider this evidence and establish such a mechanism simultaneously with the setting of the rates themselves.[81] In *Verizon Communications*, the Supreme Court concluded that it was premature to consider the ILECs' contention that TELRIC would produce a confiscatory result, because they did not challenge "particular, actual TELRIC rate[s]" and therefore it was uncertain whether TELRIC rates would enable incumbents to recover their past prudent investment or actual forward-looking costs. *Verizon Communications*, 535 U.S. at 525-28 The Court made clear, however, that once a state has determined specific UNE rates, those rates are subject to challenge on the basis that they fail to provide adequate compensation. *Id.* at 524. The Court further observed that the Commission had committed to considering "a challenge to TELRIC *in advance of a rate order*," provided that the challenge specifically showed how "a confiscatory rate is bound to result." *Id.* at 528 n.39 (emphasis added).[82]

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[80] *See Verizon Communications*, 535 U.S. at 524 (stating that UNE rates are subject to challenge as a taking at the time they are set); *Local Competition Order* ¶ 739 (recognizing that incumbents have a right to petition the Commission if TELRIC rates fail to provide sufficient compensation).

[81] *See, e.g.*, *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1176-1179 (D.C. Cir. 1987) (where regulated entity presents serious allegations that rates may result in a taking, the agency *must* consider those allegations and look at the relevant evidence; failure to do so is reversible error); *Presault v. ICC*, 494 U.S. 1, 11 (1990) (Constitution requires "reasonable, certain, and adequate provision for obtaining compensation at the time of the taking").

[82] The Due Process Clause of the Fifth Amendment also requires that a utility be afforded a meaningful opportunity to challenge rates as confiscatory. *See, e.g.*, *Michigan Bell Tel. Co. v.*

Accordingly, *before* implementing the rates produced by the *Order*, the Commission must evaluate Verizon VA's contention that those rates would produce a confiscatory result. Although the Supreme Court upheld the Commission's decision not to include past prudent investment as part of the *methodology* for determining UNE rates, the Court did not relax the bedrock requirement of the Act and the Constitution to consider incumbents' claims that the *outcome* of that methodology is a confiscatory rate.

Under sections 251(c)(3) and 252(d)(1), UNE rates must be "just and reasonable" — a standard that has long been interpreted to require rates that are compensatory within the meaning of the Fifth Amendment.[83/] In other words, the Act does not authorize the establishment of a confiscatory rate for UNEs.[84/]

The standard for determining whether UNE rates have a confiscatory effect is whether they permit the incumbent to recover its unrecovered historical costs and its actual forward-looking costs.

For nearly a century, the courts have evaluated claims that rates are confiscatory by determining whether they permit the utility *to recover its investment*, along with a return.[85/] Thus, in *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989), the Court considered whether a

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Engler, 257 F.3d 587, 593 (6th Cir. 2001); *Guaranty Nat'l Ins. Co. v. Gates*, 916 F.2d 508 (9th Cir. 1990); *Calfarm Ins. Co. v. Deukmejian*, 771 P.2d 1247, 1254 (Cal. 1989).

83/ *See, e.g.*, *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 769-70 (1968); *Federal Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942).

84/ *See Verizon Communications*, 535 U.S. at 489 (Act permits "novel ratesetting designed to give aspiring competitors every possible incentive to enter local retail telephone markets, *short of confiscating the incumbents' property*") (emphasis added).

85/ *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 601-04 (1944); *see also Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 290 (1923) (Brandeis, J., joined by Holmes, J., concurring).

slight modification of a historical cost ratemaking methodology would produce a confiscatory result by determining whether the shift adversely affected investors' opportunity to recover all their previous prudent investment and an appropriate rate of return under the old methodology. The Court determined that the new method was still projected to produce recovery that was "within the constitutional range of reasonableness" *as measured under the old methodology. Id.* at 312 Under *Duquesne*, in other words, the new system must still provide for recovery of the investments made under the prior system *and* a return on that investment that would have been constitutionally sufficient under the old system. Indeed, in a concurrence, Justice Scalia, joined by Justices White and O'Connor, observed that, for courts to determine whether a rate methodology provided a constitutionally adequate "fair return," "all prudently incurred investment may well have to be counted." *Id.* at 317.[86/]

In addition to unrecovered historical costs, a rate must also cover the actual forward-looking operating costs that the regulated entity will incur going forward. Thus, when the government compels the ongoing production of a good or service by a private party, the compensation provided must, at a minimum, cover the unavoidable costs of producing the good or service it has requisitioned and not force the entity to operate at a loss. In the case of UNEs, the incumbent is compelled to offer, maintain, and operate a portion of an *existing* network for

[86/] Likewise, the Commission itself has repeatedly recognized that incumbents are entitled to recover their unrecovered historical costs and stated its intention to provide such compensation. In the *Local Competition Order*, the Commission pledged that ILECs may "seek relief from the Commission's pricing methodology if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates" and stated that it intended to consider in its Access Reform Proceeding the creation of "a mechanism separate from rates for interconnection and unbundled network elements" to provide recovery of ILECs' historical costs. *Local Competition Order* at 15872 ¶ 739; *Access Reform NPRM* at 21360-61 ¶ 7. In its *Universal Service Order*, the Commission again promised that it would address "legacy costs" in its Access Reform Proceeding. Report and Order, *Federal-State Joint Board on Universal Service*, 12 FCC Rcd 8776, 8901-02 ¶ 230 n.593 (1997) ("*Universal Service Order*").

the benefit of a third party. The ongoing capital costs and operational expenses of using that network in order to comply with this governmental mandate are unavoidable — they must be incurred in order to offer the required facilities and services on an ongoing basis. These are costs that the government is not constitutionally free to ignore.[87]

The Commission, therefore, now has the duty to compare the *Order*'s UNE rates to Verizon VA's past prudent investment and the actual forward-looking costs that Verizon VA can achieve in order to determine if the rates are confiscatory. The Commission cannot defer its evaluation of Verizon VA's confiscation claim, it must ensure that Verizon VA is fully compensated within the meaning of the Constitution and the Act before it allows the *Order*'s UNE rates to go into effect.[88] This requires the Commission (a) to define the legal standard for determining whether the UNE rates have a confiscatory effect, (b) to evaluate the evidence to determine whether the *Order's* UNE rates are confiscatory, and (c) to provide an appropriate mechanism for recovery if they are.

And it is clear that the *Order*'s rates are in fact confiscatory. As the Commission Staff has now concluded, even TELRIC-compliant rates do not provide appropriate cost recovery. As its policy paper concludes, "if investment costs are falling over time, and the period between

87/ *United States v. Pewee Coal Co.*, 341 U.S. 114, 117-18 (1951) (plurality opinion) ("When a private business is possessed and operated for public use, no reason appears to justify imposition of losses sustained on the person from whom the property was seized."); *United States v. General Motors*, 323 U.S. 373, 379-83 (1945) (holding that when property is occupied by government mandate, the owner is entitled to recover his actual costs based on his particular circumstances).

88/ *See, e.g.*, *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1176-79 (D.C. Cir. 1987) (when a party raises allegations that particular rates are confiscatory, or are not "just and reasonable," the agency entrusted with that decision *must* evaluate that claim); *Preseault v. ICC*, 494 U.S 1, 11 (1990) (Constitution requires "'reasonable, certain, and adequate provision for obtaining compensation' at the time of the taking") (quoting *Regional Rail Reorganization Act Cases*, 419 U.S. 102, 124-25 (1974)).

TELRIC price adjustments is shorter than asset lives, then traditional TELRIC pricing will not permit incumbents to recover the cost of their investment."[89] That shortfall is of course exacerbated by the *Order*'s radical interpretation of TELRIC here. Indeed, the rates resulting from the *Order* will permit Verizon VA to recover neither its unrecovered historical costs nor its actual forward-looking costs. For example, based on Verizon VA's preliminary calculations, UNE-P rates produced by the *Order* are less than *one-half* the historical cost of providing the UNE-P. And those rates likewise are well below Verizon VA's *actual* forward-looking costs.

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[89] OSP Working Paper at 1; *see also id.* at 1-2 ("Indeed, when investment costs are falling over time and TELRIC price reviews are conducted at intervals shorter than expected asset lives, the firm will earn less than its target rate of return under traditional implementations of TELRIC."); *id.* at 43 ("When investment costs are falling by 11% per year (as is assumed for switching assets in the FCC Synthesis Model), the TELRIC correction factor is approximately *50%*. That is, switching prices should be increased by *50%* from those suggested by Synthesis Model runs.") (emphasis added).

CONCLUSION

For the reasons stated above, the Commission should grant Verizon VA's application for review.

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CERTIFICATE OF SERVICE

I do hereby certify that true and accurate copies of the foregoing, Verizon Virginia Inc.'s Application for Review, were served by hand delivery via courier this 29th day of September, 2003, to:

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